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SUBJECT: NEW ZEALAND REACTS CAUTIOUSLY TO U.S. ECONOMIC  
DOWNTURN

¶1. Summary: New Zealand politicians along with its Reserve Bank reacted cautiously last week to the news of a possible downturn in the U.S economy and its potential impact on the New Zealand's economy. Attempting to soothe the concerns of the equity and export markets, the Prime Minister and the Finance Minister tried to reassure the public that NZ was on safe economic ground and its fiscal and monetary policies were capable of adjusting to any nearterm challenge. The Reserve Bank of New Zealand (RBNZ) continues to see inflation as the greatest foreseeable threat to the NZ economy and decided to keep pressure on inflationary forces by continuing to maintain its tight monetary controls (i.e., highest in industrial world.) Several New Zealand economists are also proposing that the Asian economies, which have generated most of the world's growth in recent years, have enough momentum of their own to shrug off at least a short drop in NZ exports to the U.S. End summary.

GNZ Officials Downplay Negative U.S. Economic News  
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¶2. Reacting to a two-week downturn in New Zealand's equity markets and fears of a possible recession in the United States, Prime Minister Helen Clark last week publicly extolled the resilience of the New Zealand economy to help ease investors' jitters. The New Zealand Stock Exchange's (NZX) index of its top 50 domestic companies, the so-called "NZX 50" finished last Wednesday in positive territory for the first time since its fright along with other world financial markets over recession predictions in the United States, closing eight points or 0.2 percent higher after Tuesday's initial dramatic losses. The NZ Cabinet also discussed the turmoil on world markets at its first meeting of 2008 on Thursday (1/24). Noting that the New Zealand market had reacted positively to the U.S. Federal Reserve's announcement of a rate cut, PM Clark said New Zealand was in good shape to weather this bout of international volatility. According to the PM, "the country had had years of good growth, low unemployment and skills shortages, and the net debt position was in 'very, very good shape', conditions that were the opposite of recession." "And we're in a resilient position compared with where New Zealand has been in past periods of shock so we are not unaffected, but we are more resilient than many," she said.

13. Minister of Finance Michael Cullen has also been talking down any risks to New Zealand's economy, saying talk of global recession has been "over-hyped" and it is still too early to see what kind of impact the U.S. crisis might have for New Zealand. Cullen has promised that the 2008 Budget will not include anything that might exacerbate domestic inflationary pressures. If on the other hand the economy does take a downturn, the Finance Minister has at his access a budget surplus of NZ\$1.5 billion (US\$1.2 billion) worth of possible tax cuts as potential fiscal stimulus.

14. RBNZ Governor Alan Bollard used his annual speech to the Canterbury Employers Chamber of Commerce on Friday (1/25) to reflect on some of the economic shocks New Zealand has had to contend with recently. He attempted to ease market fears by saying the country is enjoying its longest (but not strongest) expansion since World War II, accompanied by low inflation which has averaged 2.2 percent over the past 10 years but he cautioned that the reduced volatility in both prices and growth should not be taken for granted. He maintained that the challenges the Reserve Bank faced today sprang in part from the growing importance of China, India and other rapidly industrializing countries in the world economy. Their demand for fuel has seen oil hit US\$100 a barrel this month and these higher oil prices have added 0.5 percentage points a year to inflation since 2004. The emerging economies' demand for oil is not the only factor in any new price shocks the Bank has had to think about - there is also the issue of "carbon pricing." While acknowledging that much of the damage to the climate came from the accumulated stock of greenhouse gas emissions mainly from the advanced economies, it was the emerging economies which would contribute most to emissions in the future, Bollard said. The Government's principal policy to combat climate change is

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an emissions trading scheme which will raise petrol and diesel prices from the start of next year and electricity prices from 2010. The bank estimates these measures will add 0.25 percentage points to inflation next year and 0.35 in 2010.

15. In last Thursday's Monetary Policy Statement (MSP), the Reserve Bank of New Zealand (RBNZ) announced that its Official Cash Rate (OCR) would remain unchanged at the current level of 8.25 percent (one of the highest official rates in the developed world). Dr. Bollard, in releasing January's MSP said, "on balance, the outlook for interest rates is little changed from the December, but the level of uncertainty in the economy has increased." He further stated that, "although the consumer price index (CPI) level of inflation is expected to remain above 3 percent during 2008, we believe that the current level of the OCR remains consistent with future inflation outcomes of 1 to 3 percent on average over the medium term." (Translation: RBNZ not likely to change OCR in the medium term in 2008.) He based his opinion on the expectation that the New Zealand housing market will continue to cool and the labor market will remain tight at 2 percent unemployment, while domestic income growth is expected to remain strong, especially from dairy exports with core inflationary pressures still persistent. The Governor took special note of the ongoing turbulence in international financial markets and deterioration in the outlook for the United States and European economies. He said he will be watching these developments closely, particularly their implications for the Asian and Australian economies and their effect on world commodity prices.

Strength of Asian Economies May Cushion New Zealand Economy

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16. Brent Layton, chief executive of the New Zealand Institute of Economic Research said he remains optimistic for the NZ economy's prospects. He maintains that the U.S. slowdown would not amount to a full-blown recession. He is a proponent of the "decoupling theory" that proposes that the

Asian economies, which have generated most of the world's growth in recent years, have enough momentum of their own to shrug off at least a short drop in NZ exports to the U.S. He said, "I don't think Asia will slow a lot, hence the impact on Australia (NZ biggest trading partner) will not be so great, thus helping New Zealand." "Share markets volatility reflected uncertainty," Dr. Layton said. "They were not always a reliable barometer of true economic outlook." "It is only a very small proportion of the total value of equities that gets traded on any day," he said. "You can have large movements which affect the value of the market but only a small proportion of players are participating." Tony Alexander, chief economist of Bank of New Zealand is predicting the NZ economy will grow at a weak rate of below 2 per cent this year. Per Alexander, "there will definitely be an impact but there is some insulation," he said, citing the dairy boom, infrastructure spending, job security and wage growth, the prospect of tax cuts and level of businesses investing. Any fall in local fixed-term mortgage rates would be limited, Mr. Alexander said, when U.S. interest rates began to rise again later in the year as concerns about inflation came to the fore again.

17. Comment: The magnitude of the impact of a U.S. economic slowdown on New Zealand's economy will depend on how long it lasts and how much validity there turns out to be in the theory of "decoupling". That is the extent to which the Asian economies, which have generated most of the world's growth in recent years, have enough momentum of their own to shrug off at least a short drop in NZ exports to the U.S. If NZ is sufficiently "decoupled" from the U.S. market then the impact on commodity prices (particularly dairy), whose current strength underpins the growth prospects for New Zealand, should be modest. End comment.  
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